BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[REDACTED]	)	
F.E.I.N. [REDACTED]	)	**Case No. 200700189-C**
	)	

A hearing was held on February 12, 2008 in the matter of the protest of [REDACTED] (Taxpayer) to the denial of a refund by the Corporate Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for the tax year ending December 31, 2002. The record in this matter was left open until April 14, 2008 to allow for post-hearing memoranda. The Section timely filed its opening post-hearing memorandum on March 12, 2008. The Taxpayer timely filed its response post-hearing memorandum via facsimile on April 11, 2008. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

The evidence presented and the parties' joint listing of facts establish the following. Taxpayer is a [REDACTED] that provides consumer and business lending services and was created in September [REDACTED]. In September [REDACTED], Taxpayer acquired [REDACTED] (est. [REDACTED]) and changed its name to [REDACTED]. In September [REDACTED], Taxpayer established [REDACTED]. In April [REDACTED], Taxpayer acquired [REDACTED] (est. [REDACTED]). Taxpayer then merged [REDACTED] with [REDACTED], and the surviving entity was named "[REDACTED]." In

[REDACTED], Taxpayer relocated its headquarters from [REDACTED], to [REDACTED], Arizona.

On or about July 29, 2003, Taxpayer filed its [REDACTED] Arizona income tax return for the year ending December 31, 2002. Taxpayer filed an amended federal tax return for the tax year ending December 31, 2002 in or around July 2006. In the amended federal return, Taxpayer increased Federal Taxable Income and also claimed a Federal Research and Development Credit for the 2002 tax year. The Internal Revenue Service ("IRS") issued a refund to Taxpayer based on the amended federal return. On or about July 6, 2006, Taxpayer filed an amended Arizona tax return ("Amended AZ Return") to report the change in Federal Taxable Income and to claim the Arizona Credit for Increased Research Activities under A.R.S. § 43-1168 ("R&D Credit") for the tax year ending December 31, 2002. The Amended AZ Return reported an additional tax due of $[REDACTED] and sought an R&D Credit for $[REDACTED]. Thus, the overall refund sought by the Amended AZ Return was $[REDACTED], exclusive of interest.

On or about September 19, 2006, the Section issued Taxpayer a Notice of Proposed Refund Denial ("NPRD") for the refund sought by the Amended AZ Return. The tax year ending December 31, 2002 is the first tax year that Taxpayer claimed R&D Credits in Arizona. The Section based its NPRD on its belief that Taxpayer had not produced sufficient evidence to prove that it had engaged in research and development activity prior to 2002. Therefore, it determined that 2002 was the first year that Taxpayer had documented qualified research activity in

Arizona. Using the statutory formula, the Section calculated the R&D Credit for 2002 to be zero.

Taxpayer timely protested the Section's refund denial. Taxpayer argues that it was engaged in qualified research activities in Arizona as far back as 1994 through its acquired entities which existed prior to Taxpayer's creation in [REDACTED]. Using the estimated amounts of qualified research from previous years and the formula for calculating the R&D Credit, Taxpayer determined that it was entitled to a refund of $[REDACTED] for the tax year ending December 31, 2002.

Taxpayer bases its argument that it was engaged in qualified research activities in Arizona as far back as 1994 on a Tax Credit Study performed in 2006 (the "Study") by the [REDACTED] ("[REDACTED]"). Taxpayer hired [REDACTED] to determine the amount of Taxpayer's 2002 R&D Credit. As a part of the Study, [REDACTED] interviewed Taxpayer's management team, executives and employees in 2006 to determine the types and amounts of R&D activities engaged in by Taxpayer.

The Study concluded that the qualified research activities from Taxpayer's acquired entities (primarily [REDACTED]) could be used to determine the base year calculations for purposes of the R&D Credit. However, there does not seem to be any verifiable data to establish the types and amounts of R&D activity that existed prior to 2002. Indeed the Study itself declares as follows:

> **[A]ctual gross receipts and qualified research expenditures were not known for tax years 1994 and forward, thus they have been**

> extrapolated from available data in the 2000-2004 time periods. Qualified research employees, for periods prior to 2002, were derived through discussions with [REDACTED] who was a [REDACTED] employee during the initial acquisition of [REDACTED]. Their wages were extrapolated from 2001 to 1994 using a 95% regression adjustment based on wage inflation. The base wage amount was that of a software developer employed in the 2003 tax period. (Emphasis added.)

Thus, the employees interviewed by [REDACTED] did not have actual knowledge of the work performed in the acquired entities or the amounts expended on qualified research activities. Taxpayer's representative testified at the hearing that some of the information that [REDACTED] provided came from discussions that he had with a person named [REDACTED], a former employee of one of the acquired companies, during the due diligence period of Taxpayer's acquisition of the company.

At issue is the propriety of the Section's denial of Taxpayer's refund claim. Because the calculation of the R&D Credit depends upon the number of years that the Taxpayer participated in qualified research activity, the main question in this matter is when the Taxpayer began qualified research activity in Arizona.

CONCLUSIONS OF LAW

Arizona Revised Statutes (A.R.S.) § 43-1168 allows a credit against income taxes for increased research activities as determined under Internal Revenue Code (I.R.C.) § 41, subject to some modifications. One of the additional requirements of A.R.S. § 43-1168 is that the qualified research must be

conducted "in this state and paid for by the taxpayer." A.R.S. § 43-1168.A.1.

Taxpayer asserts that the IRS accepted Taxpayer's methodology, and that because (with some exceptions) the amount of Arizona's R&D Credit is determined under I.R.C. § 41, Arizona is obliged to accept Taxpayer's calculation method. The Section disagrees. In its post-hearing memorandum, Taxpayer argues that "[t]he IRS has certainly agreed with the tax treatment and the methodology employed, or it could not have legally issued the refund." However, the IRS cannot and does not audit every return of every taxpayer. Undoubtedly, there are some invalid claims and deductions made by taxpayers that result in refunds being issued by the IRS. That does not, however, mean that the IRS has illegally accepted the methodologies of the invalid claims or deductions. Nor does the IRS' processing of Taxpayer's refund claim in this case mean that the IRS accepted Taxpayer's methodology. Further, there is no law that provides that Arizona must grant a refund because the IRS granted a refund of federal taxes on a similarly based refund claim. In fact, as noted by the Section, there have been situations in Arizona where the Department's denial of a deduction was upheld even though the same deduction was claimed and accepted on a federal amended return by the IRS. *See e.g.*, *Justin's Water World Inc. v. Ariz. Dep't of Rev.*, No. 497-86-I (Ariz. Bd. Tax App. March 2, 1988).

I.R.C. § 41 generally provides for an incremental credit for "qualified research activities" (as defined in I.R.C.

§ 41(d)), but only to the extent that current year research expenditures exceed the "base amount" for that year. *See* I.R.C. § 41. The "base amount" is dependent upon how many years that a taxpayer has had qualified expenditures and the amounts of such expenditures. *See* I.R.C. § 41(b). A complex calculation is involved, and is set forth in I.R.C. § 41, and for Arizona purposes, the calculations are further set forth in Arizona Form 308. Pursuant to such calculations, if 2002 was the first year that Taxpayer had established qualified research activity in Arizona, then Taxpayer's 2002 credit would be zero.

Both parties agree that Taxpayer engaged in qualified research activities in 2002. However, while the Section claims that 2002 was the first year that Taxpayer engaged in such activities, Taxpayer asserts that it was engaged in qualified research activities much earlier. In Taxpayer's calculation of their 2002 Arizona R&D Credit, they used amounts for qualified research activities as far back as 1994. Although Taxpayer was not established until [REDACTED], Taxpayer asserted that it could use the activities of [REDACTED] to calculate the base year. Taxpayer acquired [REDACTED] in [REDACTED], but [REDACTED] was established in [REDACTED].

I.R.C. § 41(f)(3)(A) allows a taxpayer to utilize the qualified research activities of an acquired business when calculating the increased research and development credit for the acquiring company. However, Taxpayer must still establish that the acquired business had qualified research expenditures during the years prior to its acquisition.

As this is a claim for refund based upon a tax credit, Taxpayer has the burden of proving that it is entitled to the credit. In this case, Taxpayer must establish that it had increased qualified research activities in 2002. To do so, it must show that it had qualified research expenses in Arizona in years prior to 2002, and the amounts of such activities. The Hearing Office finds that Taxpayer has not presented sufficiently reliable evidence to establish that it (or the companies it acquired) had engaged in qualified research activities prior to 2002. Further, even if Taxpayer could prove that its acquired companies engaged in qualified research activities, Taxpayer was unable to establish the amounts of such activities in years prior to 2002. Therefore, the Section's NPRD is presumed correct.

As stated in the Findings of Fact section above, the basis for Taxpayer's calculation method is set forth in the [REDACTED] Study. The Study is based upon hearsay, and states that "actual gross receipts and qualified research expenditures were not known for tax years 1994 and forward." [REDACTED] determined that [REDACTED] engaged in qualified research activity prior to 2002 based primarily upon discussions with Taxpayer's CIO, [REDACTED], in 2006. However, [REDACTED] was not an employee of [REDACTED], and had no actual or direct knowledge of [REDACTED] activities prior to its acquisition in [REDACTED]. Rather, [REDACTED] based his statements to [REDACTED] in 2006 on his recollection of discussions he had in 2001 with [REDACTED], a former employee of [REDACTED]. Neither [REDACTED] nor

[REDACTED] testified at the hearing. There is no way to determine whether [REDACTED] recollection of prior discussions with [REDACTED] was accurate, nor is there any evidence to determine whether the information provided by [REDACTED] was accurate.

While likely inadmissible in a state court proceeding, the [REDACTED] Study is admissible in this proceeding because all relevant evidence shall be admitted in an administrative hearing at the Department. A.A.C. R15-10-117(B). However, because there was no direct or actual knowledge presented by the Study, the Hearing Office assigns little weight to the testimony of the existence and extent of [REDACTED] qualified research activity prior to 2002.

Because actual amounts were not available, the Study utilized a regression analysis to estimate the amounts expended on qualified research activities prior to 2002. To do so, [REDACTED] had to rely on the statements of [REDACTED] that qualified research activities were performed prior to 2002, and then estimate the wages of person(s) involved in such activity. The Section argues that the estimates should be given no weight because there was no documentation to substantiate such estimates.

Citing *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), Taxpayer asserts that "[e]stimates are clearly allowable by both the Federal Government and the State of Arizona." In *Cohan*, the taxpayer (a theatrical producer/manager) claimed entertainment expense deductions, but because he did not keep adequate

records, he could not establish the exact amount. *See id*. at 543-44. The court remanded the case to the Board of Tax Appeals in order to estimate the amount of the expenses. *See id*. However, in *Cohan*, the Board had already determined that the taxpayer had spent "considerable sums" on allowable expenses. *Id*. Thus, there was no question as to whether expenses were paid out or deductible; the only question was the amount of such expenses.

In this case, Taxpayer has not established that [REDACTED] expended any amount on "qualified research activities" as the term is defined in statute. Treas. Reg. § 1.41-4(d) makes it very clear that a taxpayer must document in advance (or in the early stages) that the research project meets the specific parameters set forth in statute. Otherwise the research performed is not qualified, and a credit will not be allowed. *See* Treas. Reg. § 1.41-4(d). Taxpayer provided no such documentation, nor was such documentation referred to in the Study. Taxpayer has not established that [REDACTED] had engaged in any qualified research activities. While *Cohan* might apply for purposes of estimating the amount expended on items which have clearly been established to be qualified research projects, *Cohan* cannot be applied for purposes of determining whether or not qualified research occurred. *See Coloman v. Comm'r*, 540 F.2d 427, 431-32 (9th Cir. 1976) (refusing to allow the *Cohan* doctrine to estimate the amount of item that was not established because doing so "would be in essence to condone the use of that

doctrine as a substitute for burden of proof"). Thus, the *Cohan* doctrine does not apply here.

Based on the foregoing, the Section properly denied Taxpayer's request for refund. Therefore, Taxpayer's protest is denied.

DATED this 30th day of April, 2008.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Audit Appeals Section